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# PRICE FIXING AND THE THEORY OF PROFIT

## SUMMARY

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## I

PRICE fixing represents one of the most important economic novelties that resulted from the war. Whether prices first rose as a result of the sudden and abnormal demand caused by the war or whether the effective cause of the general increase in prices was the enormous expansion of currency and credit, price control served as a check both on the expansion of paper and on the elevation of the price level. High prices were obviated, and the expansion of currency was impeded. It is doubtful whether the economic significance of price control was realized or understood by the various price-fixing agencies of the United States government. A considerable number of special and different reasons influenced these different agencies in fixing the price of different commodities. In some cases one reason or purpose was predominant, in other cases more than one or even all of the reasons and purposes were responsible.

Prices were fixed for two great classes of purchasers: the commandeering departments of the government and the consuming public. When the government com-

mandeered, prices were fixed so that, by the prevention of profiteering, governmental expenditures might be reduced. Prices were fixed for the public so that the psychology of high prices and the exploitation by profiteers might have no chance to breed discontent. The margins of jobbers and retailers were restricted more extensively in the case of foods and fuel, where the consuming public was more directly affected. But there were other reasons and purposes that influenced particular price fixings. A notable example was the first fixing of the price of wheat — a minimum price fixed to insure an adequate production.

Congress fixed this minimum price of wheat by legislative enactment. The president, himself, fixed the first prices for bituminous and anthracite coal. The great purchasing departments of the United States government, the Army, the Navy, and the Emergency Fleet Corporation fixed the prices at which they commandeered. In some cases these organizations did not agree with each other as to a proper price (as in the case of fuel oil prices); in a number of cases they fixed different prices for each manufacturer (as in the case of some of the food prices). The purchasing departments were helped by the War Industries Board, the Food Administration, the Fuel Administration, and the Federal Trade Commission. The principal reason for the appointment of the Price-Fixing Committee of the War Industries Board and of the Food Purchase Board was the standardization of prices.<sup>1</sup> The Price-Fixing Committee fixed the prices of all the more important staples; in many cases they furnished or allotted these staples to the producers who were manufacturing war materials. The Food Administration and the Fuel Administration

<sup>1</sup> The Food Administration, the Army, the Navy, and the Federal Trade Commission were represented on the Food Purchase Board. These departments and others were represented on the Price-Fixing Committee.

controlled the prices of foods and fuels; their work was for the benefit both of the purchasing agencies of the government and the consuming public. The Food Administration was authorized to fix margins of profit above cost, but was not supposed to fix prices. The Food Purchase Board, however, was authorized to fix prices. There were several unique cases of price fixing: in the case of the news print paper, the Federal Trade Commission, the Department of Justice, and a federal court, all had a part; in the case of rubber and hemp, the War Trade Board fixed the prices.

The number of agencies that fixed prices and the different reasons and purposes of the particular price fixings gave rise to several different methods of price control. These methods may be divided into two general classes — corresponding to the two types of price determinants. Most economists believe that price is determined at any one time by the forces of supply and demand, but that over considerable periods price tends to be equal to the marginal cost of production. In the first kind of price control, the factors of supply and demand were emphasized; in the second, the cost of production was used as the basis of the price fixing. If, at any particular time the demand becomes abnormally great and the supply cannot be increased sufficiently, prices rise and the entrepreneurs reap unwonted profits. This was true of the period during the war. Thus, when the forces of supply and demand allowed such abnormal profits in all branches of industry, it was thought necessary to maintain prices artificially at about the marginal cost of production. However, in some cases the forces of supply and demand, as they existed before the war, were used as the price determinants.

Only a few sentences are necessary to dispose of the first kind of price fixing, which was used in but few in-

stances. In some few cases prices were fixed at the point prevailing in the market at the time of the price fixing. In anticipation of a rise, prices were held at what seemed a reasonable figure. Such price control represented a convenient expedient, and showed no evidence of a carefully worked out method. In other cases, an average of prices over a number of years was used as the basis of the price fixing. Such an average price could have been assumed to be a normal price — or a price approximately equal to the average marginal cost of production. However, the marginal cost of production in 1917 or 1918, even if there had been no war, might have showed wide divergencies from the average marginal cost of production. If, for example, there had been a marked decrease in the production of flour sacks in 1917 and 1918, the resultant shortage, which would have been in no wise related to the war, should have been allowed to have some effect on the price of flour. An average of pre-war prices would probably not have shown the effect of such a special condition, whereas the cost method of price determination gave every fact of that kind a proper amount of importance. An average of prices, furthermore, would have made no allowance for the effect of the general rise in prices due to the increase in currency.

The cost method of price fixing built up prices from the elements in the entrepreneur's cost, whereas the first method took a price or an average of prices already created by the forces of supply and demand. The cost method was the more practicable method and was used in nearly every case.

A number of variations of the cost method of price fixing were employed. In some cases, prices were fixed after the production had been completed; in other cases, prices were fixed before the production was under-

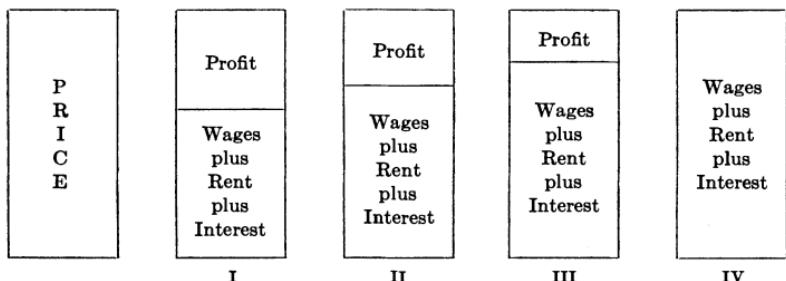
taken. (In such cases future costs had to be estimated.) In still other cases the problem was somewhat more complicated: e. g., prices were set for some of the food-stuffs before they had been produced; later, as a result of the objections of certain of the manufacturers, the costs of those manufacturers were investigated and the prices paid for their product were amended where necessary. Ante-production prices represented a standard price for all manufacturers, whereas post-production prices may have varied for different manufacturers. In ante-production price fixing two considerations had to be borne in mind by the price-fixing agencies in setting a single price for the entire industry; first, the price had to be high enough to insure the production needed in any particular case; second, the price had to be low enough to prevent unduly large profits. The ante-production price fixing represented the most important and the most difficult kind of price control.

## II

The economic analysis of the relation of cost of production and price under competitive conditions might be represented graphically. In order to make such representation it would be better to select an industry in which the product was a staple of a standard grade. It should be taken for granted that all manufacturers sold this grade at the same price. It would be helpful, moreover, to assume that the producers or entrepreneurs borrowed their capital.

Group I represents the most efficient producers and Group IV represents the least efficient producers, i. e., the marginal or no-profit producers. The manufacturers represented in Group IV would have had to reduce their expenses or forego profits. (It is assumed

that competition standardized price so that the producers in Group IV could obtain no more for their product.) If these conditions be taken to represent a



competitive, tho artificial, market the problem of price fixing presents no great difficulty. If the production of Group IV was found to be necessary, the price fixed had to cover the wages, rent, and interest paid by the manufacturers in that group. A bare economic analysis, then, made prices equal to the wages, rent, and interest of the least efficient producer.<sup>1</sup> It will be shown later that the manufacturer's expenses can be analyzed roughly into wages, interest, and rent. (This is not strictly true except for producers in the very first stage of production, inasmuch as manufacturers who do not produce their raw materials have an element of profit in their expenses. See p. 145.) The expense figures, then, which were chosen for price fixing when the price was intended to stimulate production, were naturally those of the least efficient producers. If only a part of the production was needed, the figure chosen had to be just high enough to cover the expenses of all of those producers whose output gave the needed supply.<sup>2</sup>

<sup>1</sup> His expenses represented the marginal cost of production.

<sup>2</sup> The least efficient producers who remained in the industry were then assumed to be the only marginal producers whereas some of the more efficient producers were often marginal producers in that the fixing of a price which they considered unsatisfactory might have induced them to go into the production of another product for which their plants were suitable and on which they might have been able to realize an even greater

Altho the cost method of price fixing was based on an economic analysis of the relation between cost and price, the economic cost of production was developed from the accounting cost of production. The accountant's cost represents the producer's cost or expenses, and is somewhat different from the economist's cost. The producer's profit is an element in the economic cost of production, whereas the accountant ordinarily thinks of profit as a differential between selling price and cost. By cost, the accountant means the current expense or the money spent to pay for the production in the period. As a rule, altho not invariably, the amount of money included in cost must be paid to others—thus, no rent is allowed on land owned by the producer or corporation. Furthermore, the expenses must be current—thus, no return on permanent investment is allowed in cost. The accountant does not consciously classify the parts of cost or price according to the factors of production but separates the current expenses, which commonly represent payments to others, from the interest or return on the permanent investment, which may or may not be owned by the producer.

Whether the accountant has any conscious classification and whether he follows it consistently are matters on which the later discussion of this paper may throw light. Nevertheless, altho he does not classify in the way that the economist would, his cost statements furnish the material for a thorogoing economic classification. In order to show that the items into which the

profit. Of course, successful price fixing was predicated upon general price fixing. Therefore, if prices generally were fixed it would have been questionable economics to attempt to restrict a producer to one product if he could have produced another more economically. Furthermore, there is no reason to believe that the movement of entrepreneurs and of capital would have been in one direction; with a general price fixing, it was to be expected that some of those producers in allied industries, who were supermarginal producers, might have come over to the industry in question. When, however, a large production of a particular commodity was especially desired, it was necessary to increase materially the margin above wages, rent, and interest in constructing the selling price.

accountant analyzes cost may be considered analogues of the shares in distribution claimed by the several economic factors, a careful analysis of the elements of cost seems necessary.

The entrepreneur theoretically need not furnish his personal services in production; he need not own his land or buildings; nor need he have capital for his undertaking. Therefore, the entrepreneur must pay wages, rent, and interest. Roughly speaking, these are his costs; yet, the accountant's treatment of these items is not so simple as this theoretical analysis of cost would seem to imply.

The first element in the producer's cost of production is the raw material which is to be manufactured. This raw material represents embodied labor, land, capital, and entrepreneurial effort, and could, if necessary, be reduced to wages, interest, rent, and profit. The accountant is only interested in showing that the amount of money, which is represented by "Raw Material," is the exact amount the producer had to expend — not the raw material purchased during the period, but the raw material actually used in the production during the period.

The second element in cost is "Labor" or "Wages." When the producer or entrepreneur is actively engaged in the business, his salary is not included in "Labor" but in the "General and Administrative Expense." If the business is incorporated usually some of those actively engaged are stockholders, i. e., entrepreneurs. Their salaries are included in "Salaries of Officers." The inclusion of salaries of stockholders in cost becomes questionable when the accountant's classification is considered. Such salaries are not actually paid to outsiders unless the officers of a corporation be considered as such. One method of hiding profiteering was the in-

flation of cost by the inclusion of rapidly increased salaries.

The entrepreneur of economic theory need own no land and need pay no rent. A large number of entrepreneurs, however, do own their land and have to pay rent. It would be natural to expect that the accountant would include in cost the rent which such an entrepreneur would have had to pay, had he not owned his land. However, most accountants do not allow rent of this kind as a cost item. They insist that such an item is not absolutely calculable; that it is not one of his expenses in the sense that the raw material and the labor for which he must pay are expenses, but that it represents a return on his invested capital. In other words his investment in land should be looked upon as any other capital investment on which the return is determined by the rate of interest.

Implicit in the argument for the exclusion of rent from cost is the assumption that interest on investment is not a cost item. Interest on investment includes bond interest. Some accountants believe that interest should be included in cost on the ground that capital is an expense of the same kind as labor or raw material. The accountant who refuses to include it in cost, makes a very marked distinction between expenses, which must be paid to others for goods or services rendered, and the allowance for a return on the capital invested in the business by the producer. An estimated return on investment is not considered an expense. Rent, which the producer actually pays, is allowed in cost, but an estimated rent on land owned by the producer is excluded; the land which the producer owns is considered a part of his investment. Interest on short term notes (notes for less than a year) is usually allowed, but interest on permanent liabilities (i. e., investment) is excluded. If

a producer has invested his own capital, he is not allowed to include in his cost an estimated interest on his investment.<sup>1</sup>

The inclusion of the other elements in cost should be comprehensible after this analysis. Supplies, repairs, and the other current necessities of a business are allowed in cost. Supplies and repairs, as in the case of raw materials, can be analyzed into wages, rent, interest, and profit. Investment in machines, which are expected to last for a long period, is not allowed in a monthly or even a yearly cost.

Such accounting costs for a large number of producers were obtained by the price-fixing agencies.<sup>2</sup> If production of the commodity, for which the price was to be fixed, needed to be stimulated, the cost chosen had to represent that of the highest cost producer.<sup>3</sup> The costs obtained represented completed production; thus, for ante-production price fixing such costs had to be amended by estimating anticipated increases in materials and wages. If only a part of the production was needed, the cost chosen had to be just high enough to insure that part of the production. For example, if only 75 per cent of the production of a certain commodity were needed, and if 75 per cent of that commodity were produced at a cost less than \$1.00, the cost chosen would

<sup>1</sup> Depreciation on fixed assets is allowed. If money is invested in the bonds of a corporation or left in a commercial bank, not only is a yearly interest paid but the capital is returned unimpaired after a definite period. However, if a producer invests his capital in tangible assets, which are subject to depreciation, he has nothing of his original capital goods after a period of time. For this reason he must put by a definite sum yearly in order to cover the cost of the capital goods in which he invested. Thus, altho the interest on his capital investment is not allowed in cost, the current depreciation on his capital goods can be included. It should be noted that the depreciation is not paid out, i. e., it is not an actual expense, but is in the nature of an investment charge in that its purpose is to replace investment.

<sup>2</sup> The accountant obtains unit costs for the purpose of price fixing by adding the items of cost enumerated and by dividing the sum by the number of units produced.

<sup>3</sup> In most cases, some few very high cost producers were deemed so inefficient that their costs were disregarded. The cost chosen was often called the "bulk-line cost" — i. e., the cost that covered the bulk of the production.

have been approximately \$1.00. It should be noted that even to the cost of the least efficient producer, a margin had to be added inasmuch as the accountant allowed in cost no interest on borrowed money or on investment.<sup>1</sup>

Altho the foregoing analysis seems to present the economically proper application of the cost method of price fixing, there were many variations from it in actual practice. In a number of cases the average cost rather than the high cost was used as a basis for price.<sup>2</sup> In

<sup>1</sup> Some of the price-fixing agencies allowed a percentage of cost as the margin. This method of price determination was used in fixing prices to be paid to individual producers, whose goods had been commandeered. Obviously such a method encouraged a padding of costs. It was to the manufacturer's advantage to have as high a cost as possible if his margin was to be determined on that basis. Indeed, if each manufacturer had been paid on the basis of his own cost and a fair return on his investment, there would have been little inducement to economize. A general price for all theoretically made every producer try to become a low cost producer in order to make his margin, which was a differential varying inversely with his cost, as large as possible. An ingenious accountant attempted to prove that a percentage of cost would have amounted to about the same thing as a percentage of investment. His contention was based on the fact that in those periods when costs were high a larger investment became necessary. His argument was invalidated by the fact that the high cost producer might have been expected to show a low investment per unit of product, whereas the low cost producer should theoretically have had a large investment. Thus, when the "cost plus" method was employed, the margin above cost allowed the high cost producer was much larger than it should have been.

<sup>2</sup> Since this paper was written, Professor Taussig's "Price-Fixing as Seen by a Price-Fixer" has been published in the Quarterly Journal for February, 1919. Professor Taussig explains that the cost chosen as a basis for price was determined by the quantity of production needed. This cost was called the "bulk-line" cost (i. e., when the bulk of the production was needed); and the producer who produced at such cost, the "bulk-line" producer. This cost, Professor Taussig asserts, was usually found at the point which included from 80 per cent to 90 per cent of the production. Thus, the "bulk-line" cost was not necessarily the highest cost. "Extreme high costs in individual cases are part of the flotsam and jetsam of economic life — accidents, of no real significance."

Professor Taussig speaks of this "bulk-line" producer of the price-fixing period as the marginal producer of that period, i. e., the price determining producer. He apparently considers that all of those producers above the "bulk-line" producer are the flotsam and jetsam of economic life. He does not think, however, that price fixing on "the basis described is the same as that which would obtain if normal forces were working under normal conditions." Professor Taussig thereupon urges an interesting justification for the average cost, which it is well known the Price-Fixing Committee used in some cases in price determination.

To quote his words: "If the differences in cost which are indicated on these charts rest on physical causes — if they are due to forces in nature, not in man — the normal or long-period price may be expected to conform to marginal cost. But if they rest on the differing abilities of men, the normal price may be expected rather to conform to average cost, or at all events to fall below the bulk-line. . . . Assuming that the object to be attained is conformity to fair price in the sense of long-period or normal

most cases, furthermore, it was not the high cost producer's investment but the average investment that was

price (an assumption of which more will be said presently) the answer would be, marginal cost if the differences in cost arise from causes in nature, but average cost (or something like it) if they arise from differences in managing ability. The marginal producer, if in that position because he is the least capable person, is not the one whose conditions of production are decisive. Such a producer as has just been intimated, is probably in process of disappearing. He will disappear very soon in times of depression, will drop out gradually and haltingly in ordinary times, will hold his own with deceptive prosperity and success in periods of strong demand and unusual general profits. He is not a representative producer: not a person whose operations determine the long-period price range."

First, Professor Taussig in this place chooses to define the marginal producer — and this is for long periods — as the producer who drops out, or who may be expected to drop out. It is just as possible and probably advisable to define him as the producer who just stays in. The producers who drop out might well be called the flotsam and jetsam of economic life, and the producers who do not drop out might be called the "marginal or price-determining producers." A definition of the marginal producer as the producer who is able to keep on producing from year to year may or may not exclude the highest cost producers of the price-fixing period. It would be easy to determine just in how far the highest costs of the price-fixing period were the costs of the "fly-by-nights." Professor Taussig says "it would not be in accord either with current economic theory or with business experience to give to the least efficient manager (even if the extreme cases or "freaks" be disregarded) a dominant price-determining position. The representative firm (wherever in the scale it is to be found) is in that position." To say that the marginal cost principle gives the least efficient producer a dominant price-determining position is very much like saying that the last of the ten men pushes the stone.

Second, the Price-Fixing Committee apparently used the weighted arithmetic average cost, which it seems difficult to justify. When he argues for the average cost (or something like it) he is probably arguing for the modal cost. The correspondence of the arithmetic average and the mode would assume the dispersion of a normal frequency curve, to which cost data often do not conform. In other words, the average cost may be a very artificial figure, and may not be the cost of the representative producer at all.

Professor Taussig's distinction between the two causes for cost differences—the physical and the human—constitutes probably the most important part of his discussion. Obviously it would be difficult to determine in how far natural causes and in how far human abilities were responsible for the particular positions of producers in the cost relation. To determine the comparative importance of ineradicable differences in soil or ore bodies, of engineering efficiency, of fortuitous success or mishap, of good or bad plants and equipment would be difficult, perhaps even impossible in many cases, as Professor Taussig would be willing to admit. However, if it could be assumed, as he seems to imply, that the cost relations of mining products are more affected by physical causes, and the cost relations of manufactured products by human ability, certain questions arise. He believes that the several miners would stand in somewhat the same cost relation to each other from year to year, but that manufacturers would not. He is apparently more convinced of constant differences in soil fertility, etc., than in human ingenuity. But even if this were so, the marginal manufacturer might be a red-haired man one year and a black-haired man the next year, and yet the marginal cost might not be changed. He admits that the marginal cost may not shift appreciably, even tho there be shifts of the producers who are incurring it. "After all in any set of concrete facts, anywhere and at any time, we cannot expect to find more than approximations to economic normality" are Professor Taussig's words. It is more a matter of marginal product and marginal cost than of marginal producer. Whether the high-cost manufacturers tend to disappear more rapidly than the high-cost miners is another question, and is dependent upon the particular conditions of demand. It is probably as common

employed for calculating the margin above cost. Indeed, the common practice of the most thoughtful of the price-fixing agencies was the addition to the average cost or the high cost of a margin representing a percentage of the average investment. This return was supposed to represent a combination of interest and profit. Thus, profit was assumed to bear a definite relation to investment.

Few tenable theories of profit consider that the profit of any one entrepreneur has anything to do with his investment. Economists would immediately recognize that the foregoing analysis—in which price was considered the sum of the high cost producer's cost and interest on his investment—assumes Francis A. Walker's theory of profit. It was, of course, necessary to assume some theory of profit. One of the most important reasons for price fixing, as has been explained, was the prevention of profiteering. In some few cases a minimum price was fixed so as to guarantee the producers a certain profit, but this was not the usual practice. At a time when the abnormal conditions of demand and the peculiar limitations on supply allowed producers to reap a profit which was unjustifiably large, price fixing was found necessary in order to restrict rather than to guar-

for mines to be closed up as for manufacturing establishments to be shut down. Indeed, if the law of increasing return can be assumed for manufacturing operations, and the law of decreasing return for mining operations (and this is no forced assumption), in the face of an increasing demand and an increasing price the marginal manufacturing costs would theoretically be somewhat more stable from year to year than the marginal mining costs. Of course, it cannot be assumed that because we have had rising prices that we have had a general increased demand for all products; and, with the assumption of a decreased demand, marginal mining costs would theoretically be less affected than marginal manufacturing costs. It might be interesting to note, furthermore, that the choice of the marginal cost for industries where profit arises from artificial advantage and the choice of the average cost where man is responsible for his gain seems to penalize ability, unless it is believed that the entrepreneur should be rewarded for having discovered or utilized the better natural resources.

Finally, Professor Taussig's charts and figures probably represent costs exclusive of interest, altho he does not state this explicitly. This is a matter of considerable importance, as the apparently inefficient producers may be operating with a very small investment per unit of product, and may not be high cost producers at all, if their interest on investment be taken into consideration.

antee profits. To a large extent, then, price fixing was profit regulation. When the producer's cost was used as a basis for price fixing, all of the factors of production, with the exception of the entrepreneur, were given practically what the free competitive market enabled them to get. No theory of wages or of rent was necessary in a cost analysis. The cost accountant allowed as much of these elements in cost as was actually paid. But, inasmuch as price fixing presupposed profit determination, some theory of profit was indispensable.

At this point it seems necessary to discuss the theory of profit — particularly in its relation to price fixing.

### III

The economist is called upon to answer certain fundamental questions in formulating a theory of the entrepreneur and of profit. First, the economist must determine who the entrepreneur is and what he does, i. e., his place in production. Second, he must explain how profit comes about and how the different rates of profit arise, i. e., the entrepreneur's share in distribution. Third, the economist must justify (or make clear that there is no justification for) profit. In the third part of the theory of profit, it must be proved that what the entrepreneur does is worth what he gets; a mere explanation of how profit arises does not constitute a social justification for its existence.

The theory of profit was developed late in the history of economic thought. The entrepreneurial function and its importance in modern industrialism was perhaps first clearly set forth by Francis A. Walker. The period between Walker and the modern theorists, Clark, Schumpeter, and Davenport — who seem to consider the entrepreneur the pivot on which production and dis-

tribution hinge — has been filled with theories of profit. Walker's theory of profit showed an advance over the earlier theories both because he attempted to analyze the peculiar service of the entrepreneur and because he attempted to explain the rate of profit. The industrial experience with which Walker was familiar undoubtedly helped him to formulate his theory of the entrepreneurial function. Walker saw that the rate of profit was not fixed or stable but varied for different entrepreneurs just as rent varied for different pieces of land. He saw that profits were the differentials existing between costs and prices and naturally varied inversely with costs (producers' or accountants' costs). He contended that the cost of the marginal entrepreneur, i. e., the no-profit entrepreneur, fixed the price that prevailed in the market.

Altho Walker recognized the entrepreneurial function, many of the later economists were not entirely satisfied with his description of that function or with his justification for profit. Walker apparently believed that the coördinating, directing effort of the entrepreneur, who managed to keep his cost below the marginal cost, was a sufficient justification for profit. In other words, the ability of an entrepreneur to be a (relatively) low cost producer was both the reason for and the measure of profit. Walker insisted that it was efficiency or ability rather than artificial advantage that explained the (relatively) low cost producers; in this way he answered the socialistic exploitation theory of profit.

J. B. Clark's theory of profit offers no real justification for pure profit. Clark considered the entrepreneur a composite person, who performs two unlike functions and receives two distinct rewards. In his first capacity, he is a directive laborer, whose compensation is in the nature of wages; in his second capacity, he is a buyer

and seller, who owns the product and who makes a profit by selling it.<sup>1</sup> In this capacity he apparently does little to earn the profit.

The reward of the entrepreneur in his capacity as owner of a product comes to him as rain from the clouds, through the action of forces lying beyond the range of his dominant influence. He has nothing to do but to receive it. He must accept what comes into his treasury, and submit to what goes out of it; the difference, which is pure profit or loss, is fixed without appeal.

Hawley subscribed to Clark's belief in the ownership of the product as the peculiar function of the entrepreneur, but Hawley insisted that profit is earned because of the risk inherent in the ownership of the product. He took great pains to distinguish between the risk inherent in the use of the capital and the risk inherent in the ownership of the product. The coördinating or directing ability of the entrepreneur, he thought, earns him wages but not profit. "A farm hand," wrote Hawley, "who suggests that something be done on a farm and is told to go ahead and do it earns wages and not profit."

These three theories of profit are probably the most original contributions to the subject made by American economists.<sup>2</sup> It is interesting to consider how they answer the three fundamental questions which the theory of profit must answer. Walker believed that the entrepreneur was the director of the organization. Clark and Hawley, however, considered that his essential function was the ownership of the product. Walker asserted that profit arose when the entrepreneur produced at a cost lower than that of the marginal producer. Clark offered no justification for pure profit. The entre-

<sup>1</sup> It is important to note in this connection that the accountant allows the directive laborers' salaries, which are included in cost.

<sup>2</sup> It is regretted that the scope of this paper does not admit of a discussion of some of the other important theories of American economists — e. g., Carver, Davenport.

preneur, as directive laborer, received a wage. But the entrepreneur, as owner of the product, received profit or loss as rain from heaven; he was the beneficiary of dynamic changes. Hawley attempted to justify profit by emphasizing the risk inherent in the ownership of the product.

A description of the entrepreneur and of his function must take into consideration the fact that in most modern business organizations "the stockholders of a corporation as a group ultimately form its entrepreneur, and the bondholders merely supply the capital factor."<sup>1</sup> Of course, the distinction between a stockholder and a bondholder is often hard to recognize. The investor who buys a few shares of common stock performs no very different function from the investor who buys a bond. Both supply the corporation with capital; neither have any very real control. The stockholder theoretically has a small amount of control and the bondholder has a certain amount of contingent control. The stockholder, however, expects a higher return, at least during certain periods, apparently because the claim of the bondholder on the income of the corporation is prior and more secured. The hybrids, income bonds and preferred stocks, illustrate the difficulty in drawing hard and fast distinctions between stocks and bonds.

It might be important to draw a distinction between two classes of stockholders: (1) the stockholders who buy for investment; (2) the stockholders who own a sufficient amount of the stock to exert a real control. The investing stockholders furnish capital, and are not very different from bondholders except that they take a larger risk. They perform no real entrepreneurial function

<sup>1</sup> See Haney's "Business Organization and Combination," p. 8. The Macmillan Co., New York, 1913.

except in a vague indirect way. The second class of stockholders constitute the entrepreneur. Their return may be no different from the return of those in the first class, but the justification for it is very different. The fact remains, however, that the body of stockholders, or a part of the body acting through the directors, is ultimately responsible for the success of the corporation. They direct and control their organization in the same sense that the American people direct and control their government. The administration of a country actually directs it, but the administration is responsible to the people. The laborer, as Hawley insisted, may have a part in the direction of policy, but he is ultimately responsible to the entrepreneur or stockholders. The efficiency engineer, as Veblen suggests, may deserve the credit for a low cost of production; but he is employed and discharged by the directors, who in turn are responsible to the stockholders.

The control of the corporation ultimately rests in the hands of the entrepreneur. The ownership of the product, furthermore, is another of his functions. An entrepreneur may have many functions, but it is important to define his essential functions in order to justify profit. The shoe repairer, for example, who might conceivably own his own land, shop, and capital, and who might hire no laborer thinks of his entire selling price as profit. A highly developed economic theory, however, would analyze the functions of such a shoe repairer as follows: landowner, capitalist, laborer, owner of the product, and director. The function of the director might be divided and subdivided. From this point of view the classification of the factors of production as three or four clearly defined units may seem a misleading simplification. There are a great many factors which enter into production even tho all of them may be embodied in one

person—as in the case of the shoe repairer. The economist, however, can only deal with the essential forces which function in the productive process, and usually attempts, for practical purposes, to identify these forces with definite and existing classes of persons. The economist, thus, does well to disregard or to subordinate the less essential functions of the different factors of production. The essential functions of the entrepreneur are the direction of policy and the ownership of the product.

The second problem that confronts the economist is the explanation of how profit comes about and how different rates of profit arise. Certainly, the direction of policy and the ownership of the product do not explain the existence of profit. The entrepreneur may direct the corporation, own the product, and yet earn no profit. Profit arises when the entrepreneur buys or produces more cheaply than he sells. Altho there are different kinds of profits ranging from profit on real estate transfers to jobbing profit and manufacturing profit, profit arises when the entrepreneur, as director of the undertaking and owner of the product, sells at a higher price than he buys or produces. In a competitive market for a standardized article under normal conditions (i. e., when neither demand nor supply is abnormally great or small) price tends to be equal to the marginal cost of production and profit is, therefore, a differential between the marginal cost and other costs. But when there is no competition (as in the case of monopolies), or where there is no standardization (as in the case of some classes of real estate, or some articles advertised as "specialties"), or when demand and supply are abnormal (as in the period during the war), price varies widely from the marginal producer's expense and profits or losses bear no relations whatsoever to costs of production.

The explanation of how profit arises may constitute no social justification for it. The entrepreneur's function in production must justify or fail to justify his share in distribution. The theories of Walker and Hawley represent two different methods of justifying the entrepreneur's claim to profit. Walker's theory, however, explains how different entrepreneurs are entitled to different rates of profit, whereas Hawley's theory does not. In a competitive market or in a price-fixed market where price is approximately equal to the cost of the marginal producer, profit is earned by an entrepreneur when his cost is kept beneath that of the marginal producer and the amount of his profit is determined by the extent to which he can reduce his cost. This represents Walker's justification for profit.

Hawley attempts to justify the entrepreneur's profit by the risk inherent in owning the product. There seems to be no risk in ownership, *per se*, that would warrant compensation. The risk in the ownership of the product can be analyzed into two parts: the risk inherent in the possibility of not getting profit, and the risk of losing the capital or a part of the capital invested in the product. With respect to the first kind of risk, no factor in production is absolutely assured of a share in distribution. This is true of the laborer, altho it is more conspicuous in the case of the capitalist and land-owner. If an entrepreneur were to be compensated according to the risk he ran of getting profit, the most inefficient entrepreneurs could expect the highest rate of profit. With regard to the second kind of risk, Hawley acknowledges that this is a capitalist's risk and not an entrepreneur's risk. If the entrepreneur uses his own capital, he takes a risk as capitalist and not as entrepreneur. If he borrows his capital, the lender takes the risk. The risk inherent in the ownership of the product

offers no sufficient justification for profit nor does it explain the variations in profit. The justification for the varying yields on capital due to different degrees of risk has been generally recognized. The capitalist does not only take the risk of not getting interest but he stands the chance of losing his capital, i. e., the source of his income. When a laborer is paid a high wage in a dangerous occupation, he is compensated for the risk of losing his life or limb and not for the risk of losing his wage.

A qualification of Walker's theory of profit represents the most satisfactory theory that has been evolved. Profit is justified because the entrepreneur directs or is responsible for production which is more efficient than the marginal production. There are two factors, however, which Walker's theory either neglected or failed to emphasize. First, profit often results from artificial advantage rather than efficiency. Second, the higher prices obtained by expensive sales organizations for advertised articles, which represent no exceptional quality, result in profits which cannot be justified by any claim of productive efficiency.

Walker's theory of price and profit enabled the construction of a price-fixed market which could approximate a normal competitive market. To future estimated unit costs, based on the accountant's cost analysis, it was only necessary to add interest and the risk premium for the use of capital. The amount of pure interest should have been small — probably about 3 per cent or 4 per cent. The risk premium would have had to be determined in each particular case by the price-fixing agency. Such risk premiums should have varied for different producers and for different industries. Past stability of earnings or other criteria might have been employed for the determination of percentages to be allowed for risk.

After adding interest and the risk premium to all the costs obtained, the marginal cost should have been chosen to represent the price. This marginal cost would have represented Walker's marginal producer's expenses or marginal cost of production. In some cases, in order to insure the production of the marginal producers, it was necessary to add a margin above cost (including interest and the risk premium). But this margin was not a profit but a margin justified by expediency, for the marginal producer was entitled to no profit.

Even when the price-fixing agencies used the accountant's marginal cost (in which no interest was included) — they usually allowed a return of 10 per cent or 15 per cent on the average investment rather than on the investment of the marginal producer. This method was the result of certain misconceptions or of an unwarranted assumption. First, the marginal producer was allowed interest on the average investment rather than on his actual investment. Second, profit and interest were supposed to be covered by the return on investment. Such a measurement of profit in terms of investment was the result either of the misconception that profit is paid for the risk in using capital or the unwarranted assumption that there is for every producer an established rate of profit that represents a certain percentage of his investment. Thus, it was assumed that the ratio of profit earned on investment by the high cost producers would tend to be equal to the ratio of profit earned on investment by the low cost producers. This assumption implied that all entrepreneurs had about the same ability—an implication both untrue and dangerous. No theory of profit should have failed to take into consideration individual assiduity and intelligence. An entrepreneur's ability to be a low cost producer did not depend entirely upon his investment.

## IV

The proper application of the cost method of price fixing enabled an ideal approximation to a normal competitive market. Misapplications of this method, however, were numerous and unjustifiable.

The post-production method of fixing a separate price for each manufacturer may have limited profit but it encouraged extravagant reward for the other factors of production. In ante-production price fixing, where a single price was set for the industry, the exclusion of interest from cost and the use of the average investment for the determination of the margin above cost was based on a confusion of interest and profit. The accountant's misconception of profit should be corrected in that the business man depends largely upon him in the matter of price determination. The accountant's misconception of profit constitutes a future danger especially in those industries where a few of the most important producers fix prices. Such producers could be expected to take particular interest in the accountant's cost analysis. Of course, such price fixing should be declared illegal. A mere understanding of the nature of profit should show clearly that the costs of one producer or small group of producers do not constitute a sufficient basis for price determination.

KEMPER SIMPSON.

FEDERAL TRADE COMMISSION,  
WASHINGTON, D. C.